No. 93-207

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In the Supreme Court of the United States

OCTOBER TERM, 1993

JESS KRAFT AND BARBARA KRAFT, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether, on the facts of this case, petitioners are entitled to invoke Section 1341 of the Internal Revenue Code, 26 U.S.C. 1341, in computing their tax.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 8a-25a) is reported at 991 F.2d 292. The opinion of the district court (Pet. App. 1a-5a) is not reported.

JURISDICTION

The judgment of the court of appeals was entered on April 7, 1993. The petition for a writ of certiorari was filed on July 6, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Between 1973 and 1985, petitioner Jess Kraft, a licensed physician, practiced podiatry at Joel H. Haber, D.P.M, and Jess Kraft, D.P.M., P.C., a

Michigan professional corporation (the Corporation). At all relevant times, petitioner was an employee, officer, director and 50% shareholder of the Corporation. The Corporation was not a Subchapter S corporation (*Pet. App. 9a*).

From 1981 through 1984, the Corporation billed Blue Cross/Blue Shield of Michigan (Blue Cross) approximately $2,245,000 for medical services performed by the Corporation (Pet. App. 9a). When Blue Cross paid these bills, the payments "were deposited * * * in the Corporation's bank accounts where they were commingled with other funds and used to pay the Corporation's expenses, including the doctors' salaries" (*id.* at 22a). Petitioner reported his wages from the Corporation on the joint federal income tax returns he filed with his wife (*id.* at 9a).

In September 1984, a federal grand jury returned a 34-count indictment charging petitioner with illegal distribution of controlled substances and mail fraud. According to the indictment, petitioner performed foot and toe surgeries on drug dealers and users by promising them prescriptions for Dilaudid, Percodan, or Demerol and then billed and obtained from Blue Cross a total of $84,160 for the unnecessary operations (Pet. App. 9a).

In 1985, the United States filed a further one-count information charging petitioner with mail fraud. The information alleged that, between 1981 and 1983, petitioner fraudulently billed Blue Cross for services purportedly rendered to persons who were insured by Blue Cross when he knew that the services had been performed on different persons who were not insured by Blue Cross (Pet. App. 9a-10a). Blue Cross claimed

that petitioner eventually defrauded it of a total of $680,000 (*id.* at 9a).

On April 3, 1985, petitioner executed a Rule 11 plea agreement under which he agreed to plead guilty to Count 11 of the indictment (distribution and aiding and abetting in the distribution of Dilaudid) and Count 1 of the information (mail fraud) (Pet. App. 10a-11a). At the same time, the government agreed to dismiss the remaining counts of the indictment, not to seek forfeiture of petitioner's medical license, and to recommend a maximum prison term of 15 years on Count 11 of the indictment and 5 years on Count 1 of the information, to run concurrently (*id.* at 11a). The plea agreement also required petitioner "to pay Blue Cross/Blue Shield of Michigan $160,000 restitution prior to sentencing pursuant to the Victim-Witness Protection Act of 1982" (*ibid.*). The district court thereafter sentenced petitioner to seven years' imprisonment and fined him $26,000 (*ibid.*).

2. On December 20, 1986, petitioners filed a claim with the Internal Revenue Service for an income tax refund of $78,688 for 1985 on the ground that the restitution payment entitled them to compute their tax liability under the provisions of 26 U.S.C. 1341 (Pet. App. 11a). Section 1341 permits taxpayers who fall within its terms to pay the lesser of (i) their normal tax for the year in which a sum they previously had held under a claim of right is repaid, computed with a deduction for the repayment, or (ii) a tax computed without that deduction, but reduced by the amount that the tax in the year that the sum was initially received by the taxpayer would have been decreased if the sum had been repaid in the initial year. For Section 1341 to apply, (i) the item repaid

must have been included in gross income for prior taxable years because it appeared "that the taxpayer had an unrestricted right to such item" and (ii) a deduction must be allowable in the current taxable year because it "was established after the close of [the] prior taxable year * * * that the taxpayer did not have an unrestricted right to such item." 26 U.S.C. 1341(a)(1) and (2).

The IRS denied petitioners' refund claim. Petitioners then commenced this suit for refund in district court (Pet. App. 12a-13a).

3. The district court granted the government's motion for summary judgment, concluding that Section 1341 is inapplicable to the facts of this case. The statute did not apply because petitioner received his wages from the Corporation, not from Blue Cross, and petitioner "never made a claim of right to the money received from Blue Cross" (Pet. App. 3a). The court further noted that, under *Bailey* v. *Commissioner*, 756 F.2d 44 (6th Cir. 1985), the obligation to repay must arise from the same circumstances, terms, and conditions as the transaction whereby the amount was included in income. Petitioner's obligation to repay did not arise from any direct obligation to Blue Cross, but instead arose from the plea agreement (Pet. App. 3a).

4. The court of appeals affirmed. The opinion of the court by Judge Contie concluded (i) that petitioner's obligation to repay Blue Cross arose from his plea agreement, rather than from any direct duty he owed to Blue Cross, and that his claim under Section 1341 was therefore barred by the reasoning of *Bailey* v. *Commissioner*, *supra*, (ii) that petitioner never had a valid claim of an "unrestricted right" to the funds

obtained from Blue Cross by fraud, and that his payment to Blue Cross therefore fell outside the plain language of the statute, and (iii) that the fraudulently obtained funds were received by the Corporation rather than by petitioner, were never reported by petitioner "on his individual tax returns," and therefore afford no basis for recomputing petitioner's taxes under Section 1341 (Pet. App. 20a-23a).

Chief Judge Merritt and Judge Nelson filed separate concurring opinions. Chief Judge Merritt concluded (Pet. App. 24a) that Section 1341 is not available to a taxpayer who obtained funds by fraud because the taxpayer never held the funds under a valid claim of an "unrestricted right," as the statute requires (26 U.S.C. 1341(a)(1)). Judge Nelson noted that Section 1341 requires that the "item" included in the prior year's gross income (under a claim of an "unrestricted right") must be the same "item" that is later repaid. Petitioners did not satisfy this requirement because "[t]he 'item' included in the Krafts' gross income for the prior year at issue here was not a fee received from Blue Cross; it was, rather, a salary item received by Dr. Kraft from his corporation" (Pet. App. 25a). Since petitioner did not contend that he lacked a right to his salary, and since there was "no justification for piercing the corporate veil," Judge Nelson concluded that Section 1341 cannot apply to the facts of this case (Pet. App. 25a). Because petitioners did not come within the terms of Section 1341, Judge Nelson "consider[ed] it unnecessary to decide whether there is any genuine issue as to the *amount* of the fraud" (Pet. App. 25a (emphasis added)).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. Section 1341 permits a taxpayer who repays an amount he initially received under a claim of right in a prior tax year to subtract from his tax liability for the year of the repayment the amount that his tax liability in the year of receipt would have been reduced if the amount repaid had not been included in income in that prior year. 26 U.S.C. 1341(a). The tax benefit of Section 1341 is not available unless (i) "an item" was previously included in gross income "because it appeared that the taxpayer had an unrestricted right to such item" and (ii) a deduction is allowable for the current year because it has now been established that the taxpayer "did not have an unrestricted right to such item" (26 U.S.C. 1341(a)(l) and (2)). By its terms, Section 1341 thus applies only when a taxpayer has received *an item* of income (such as wages), has included *that item* in his income, and is then later required to return *that same item* (*e.g.*, his wages). See *United States* v. *Skelly Oil Co.*, 394 U.S. 678, 683 (1969) ("The 'item' referred to [in § 1341(a)(2)] is first mentioned in § 1341(a)(l); it is the item included in gross income in the year of receipt."); *Prince* v. *United States*, 610 F.2d 350, 352 (5th Cir. 1980); *Kappel* v. *United States*, 437 F.2d 1222 (3d Cir.), cert. denied, 404 U.S. 830 (1971). In other words, the statute "requires that the taxpayer's obligation to repay must arise out of the specific 'circumstances, terms and conditions' of the transaction whereby the

amount was originally included in his income."[1] *Bailey* v. *Commissioner*, 756 F.2d 44, 47 (6th Cir. 1985). See also *Blanton* v. *Commissioner*, 46 T.C. 527, 530 (1966), aff'd per curiam, 379 F.2d 558 (5th Cir. 1967).

In this case, the restitution payment was made to Blue Cross. As Judge Nelson observed, however, "[t]he 'item' included in the Krafts' gross income for the prior year at issue here was not a fee received from Blue Cross; it was, rather, a salary item received by Dr. Kraft from his corporation. * * * [A]nd there is no contention that Dr. Kraft ever remitted any part of his salary to the corporation" (Pet. App. 25a). The payment that petitioner made thus does not qualify for the benefits of Section 1341 under the plain language of that statute. See *United States* v. *Skelly Oil Co.*, 394 U.S. at 683 (under Section 1341, the item repaid is the same "item included in gross income in the year of receipt").

Petitioners contend (Pet. 29) that, although the Blue Cross funds were actually paid to the Corporation, they were received by petitioner in substance in the form of his salary payments. It has long been settled, however, that when, as here, a taxpayer has chosen to incorporate his business—obtaining thereby a wide assortment of business and tax advantages—he must also accept any tax disadvantages that may result. See, *e.g.*, *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436, 438-440 (1943); *Burnet* v. *Commonwealth Improvement Co.*, 287 U.S. 415, 419-

[1] Contrary to petitioners' assertion (Pet. 22), this statement was not dictum, but was an alternate holding. *Bailey* v. *Commissioner*, 756 F.2d at 47 ("Taxpayer is precluded from invoking § 1341 for another reason.").

420 (1932). As this Court has emphasized, it is an "established tax principle that a transaction is to be given its tax effect in accord with what actually occurred and not in accord with what might have occurred." *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 148 (1974). See also *Don E. Williams Co.* v. *Commissioner*, 429 U.S. 569, 579-580 (1977); *Higgins* v. *Smith*, 308 U.S. 473, 477 (1940); *Old Mission Portland Cement Co.* v. *Helvering*, 293 U.S. 289, 293 (1934). Moreover, petitioner offered "no justification for piercing the corporate veil and pretending that there was never any corporation in the picture" (Pet. App. 25a). Because the restitution payment did not arise from the same circumstances as the original payment, and did not represent the return of the same "item" of income, Section 1341 was not available to petitioner in this case.[2]

2. Section 1341 is also available only when, in the year of receipt, it "appeared that the taxpayer had an unrestricted right to such item" of income. 26 U.S.C. 1341(a)(1). That determination is to be made under an objective analysis that considers "all the facts available in the year of inclusion." Treas. Reg. § 1.1341-1(a)(2). When, however, the item originally reported in income "was embezzled funds[,] it is clear that it could not appear *to the taxpayer* that he had *any* right to the funds, much less 'an unrestricted right' to them." *McKinney* v. *United States*, 574 F.2d 1240,

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[2] Because the statute has no application at all to petitioner's payment to Blue Cross, petitioner's continued contention that the amount returned exceeded the amount of his fraud (Pet. 34-36) is not germane to the proper application of Section 1341 in this case (Pet. App. 25a).

1243 (5th Cir. 1978), cert. denied, 439 U.S. 1072 (1979). Courts have consistently held that Section 1341 has no application to a taxpayer who has embezzled or knowingly misappropriated funds he is later required to return, for it could not have "appeared" that the taxpayer had an "unrestricted right" to such funds. 574 F.2d at 1243; *Hankins* v. *United States*, 403 F. Supp. 257, 259 (N.D. Miss. 1975), aff'd, 531 F.2d 573 (5th Cir. 1976); *Perez* v. *United States*, 553 F. Supp. 558, 560 (M.D. Fla. 1982).

Petitioner agreed to pay restitution of $160,000 to Blue Cross as part of the plea agreement in his criminal mail fraud case. The court of appeals correctly concluded that no genuine issue of material fact existed as to petitioner's lack of a valid claim of an "unrestricted right" to possession of funds thus returned. Summary judgment was therefore properly granted. See *Anderson* v. *Liberty Lobby, Inc.*, 477 U.S. 242, 249-250 (1986) (if the disputed evidence "is merely colorable * * * or is not significantly probative * * * , summary judgment may be granted").

3. In his opinion for the court, Judge Contie stated that the restitution payment also would not be deductible currently under Section 162(f) because the payment represented a fine or penalty (Pet. App. 14a-15a). That statement was not necessary to the court's holding and was not joined by the other two members of the court. See *id.* at 24a, 25a.

The availability of Section 1341 depends not only on the current deductibility of the payment but also on (i) whether the payment to Blue Cross represented the "same item" of income that petitioner previously reported as wage income from the corporation (pages 6-8, *supra*) and (ii) whether the taxpayer held funds

obtained from Blue Cross under a claim of "unrestricted right" (pages 8-9, *supra*). Because petitioner failed to qualify under these requirements of Section 1341, the conclusion of Judge Contie that the restitution represented a "fine or penalty" was not necessary to the decision in this case. Chief Judge Merritt and Judge Nelson expressly based their concurrences on the specific requirements of Section 1341 and did not join in Judge Contie's statements concerning Section 162(f). See Pet. App. 24a, 25a. Judge Contie's analysis of Section 162(f) was thus not necessary to, and does not appear to represent, the decision of the court.

Petitioner correctly notes (Pet. 17) that in *Stephens* v. *Commissioner*, 905 F.2d 667 (1990), the Second Circuit concluded, on a different record, that a restitutionary payment was "primarily a remedial measure to compensate another party, not a 'fine or similar penalty.'" *Id.* at 672-673. *Stephens*, however, involved only the current deductibility of restitution payments and did not involve application of Section 1341. See 905 F.2d 672-673. The *Stephens* court therefore did not consider or address whether a taxpayer possesses defrauded funds under a claim of "unrestricted right" or whether a taxpayer who makes a restitutionary payment from his own funds of sums that were in fact received by a corporation has repaid the "same item" of income, as Section 1341 requires. Because *Stephens* does not address the statutory questions decided in this case, it cannot be said that the two decisions are in conflict.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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